

Banxico Minutes – Concerned about inflation, but not necessarily stopping the easing cycle

- Banxico published the minutes of the decision held on March 25th, in which the central bank unanimously kept the reference rate unchanged at 4.00%
- In our view the document's tone is hawkish, mainly because of comments on inflation and the recent evolution of financial markets, justifying the need of a prudent and cautious approach
- In line with our expectations, we saw again a heated debate about the outlook for prices, highlighting:
 - (1) Some members stating that the balance of risks is skewed to the upside, when it was previously characterized as uncertain;
 - (2) Warnings about higher inflation risk premia and possibly more-than expected persistence of core inflation to the upside; and
 - (3) That inflation expectations for year-end 2021 increased and those for the mid- and long-term remain above 3%
- We also identified comments about the evolution of financial markets, including higher medium- and long-term interest rates, portfolio outflows and a higher sovereign risk premium, among others
- Although some members considered that the easing cycle may not be finished yet, we believe the complex environment suggests that the window of opportunity for more cuts will remain closed
- Based on our call for inflation by the end of the year and market dynamics, we expect a 25bps rate hike in the decision to be held on December 16th, closing 2021 at 4.25%
- The local yield curve holds a slightly more aggressive pricing on Banxico's future movements

Banxico shows a hawkish tone. Banco de México published the minutes of [the meeting held on March 25th](#), when they unanimously kept the reference rate unchanged at 4.00%. The document's tone looks *hawkish*, mainly because of comments on inflation –with greater concerns due to a plethora of factors– and the recent evolution of financial markets which has increased the risks of to the convergence of inflation towards the target. This justifies the need of a prudent and cautious approach by the monetary authority. We also highlight opinions about whether the easing cycle –started in 2019– has ended or is in pause. We identified three members that still see room for additional cuts (if conditions allow it), with the other two without commenting explicitly on this. Despite of the latter, and based on our call of higher inflation by the end of the year (at 4.7% y/y, above consensus at around 4.1%), along likely market dynamics (with the Fed probably signaling tapering by the end of the year, among other factors), we expect a 25bps rate hike in the decision to be held on December 16th, closing 2021 at 4.25%.

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www.banorte.com
@analisis_fundam

Gabriel Casillas
IRO and Chief Economist
gabriel.casillas@banorte.com

Alejandro Padilla
Executive Director of Economic Research
and Financial Markets Strategy
alejandropadilla@banorte.com

Juan Carlos Alderete, CFA
Director of Economic Research
juan.alderete.magal@banorte.com

Francisco Flores
Senior Economist, Mexico
francisco.flores.serrano@banorte.com

Fixed income and FX Strategy

Manuel Jiménez
Director of Market Strategy
manuel.jimenez@banorte.com

Santiago Leal Singer
Senior Strategist, Fixed-Income and FX
santiago.leal@banorte.com

Leslie Orozco
Strategist, Fixed Income and FX
leslie.oroazco.velez@banorte.com

Banxico's 2021 policy decisions

Date	Decision
February 11	-25bps
March 25	0bps
May 13	--
June 24	--
August 12	--
September 30	--
November 11	--
December 16	--

Source: Banxico

Document for distribution among the general public

Extensive commentary about the inflation outlook, with the balance of risks skewed to the upside...

We consider that the debate in this front was very important and rich. We saw higher concerns about the likely path for prices, with several outstanding themes. First, some members said that the balance of risks for inflation is skewed to the upside. We should recall that, up until the previous decision (February 11th), it was characterized as uncertain. This is due to a plethora of factors, including higher global inflation expectations –primarily because of the increase in commodity prices, including energy– and a more vigorous economic recovery. All members mentioned the increase in annual headline inflation and some the recent pickup at the core. Some members thought that the upward skew for inflation is only in the short term. Nevertheless, we noted that one thinks that inflation pressures at the core level will continue because of a weaker exchange rate and pass-through effects from higher energy prices. This means that persistence to the upside of core inflation will be higher than expected previously. In this respect, there were also comments about the possibility that low services inflation could stop being a factor that compensates for increases elsewhere, with determinants for prices deteriorating.

...with higher inflation risk premia and higher expectations. Secondly, some members warned of the increase in inflation risk premia. This has been mostly driven by the pickup in these premiums globally, led by the US on expectations of a strong recovery and stimulus, among other factors. Although premiums implicit in financial instruments in our country had mixed changes since the last decision (pushed higher in 10- and 30-year tenors), one member noted that fixed-income assets have started to price-in higher inflation expectations. Regarding the latter, all members noted that inflation expectations for year-end 2021 have increased, with those for the medium- and long-term stable, albeit above the 3% target. Everyone emphasized that it is very important to keep inflation expectations well anchored.

Concerns also on the financial and macro environment. Besides inflation, there were very important comments on this given a backdrop of higher volatility and market stress. They mentioned that most of the adjustments in financial markets have been triggered by the approval of a new round of fiscal stimulus in the US, resulting in higher growth and inflation expectations. In this context, they highlighted both peso weakness and the increases in medium- and long-term rates domestically, responding largely to external pressures. Considering this, one member highlighted the steeper yield curve, signals of a deterioration in market operating conditions, and higher volatility. Meanwhile, they also mentioned an increase in sovereign risk premia, mostly due to the decline in global risk appetite, albeit with one member suggesting also some pressures from idiosyncratic risks. We noted relevant mentions on the rebalancing of investment portfolios, with a relevant risk for EMs given higher capital flows to China –partly on the addition of its financial assets to global benchmarks–. Considering the solid macro position of the Asian country, this could subtract some ‘shine’ for investments into our country, while higher global interest rates could hamper capital inflows. Finally, once again they highlighted risks related to public finances and Pemex, even despite recent support by the Federal Government for the state-owned company.

Most members argued that the easing cycle is not over yet, if certain conditions are fulfilled. In the section about monetary policy, we identified three members that explicitly stated that there is still some room for additional cuts, with the remaining two not elaborating on the matter. In our opinion, the latter could be Governor Alejandro Díaz de León and Deputy Governor Irene Espinosa, who seem to have a more *hawkish* bias. Among their likely comments, they stressed the need of maintaining a prudent stance, particularly amid a volatile and uncertain backdrop, such as the one we are experiencing. Nevertheless, at least in the case of the Governor, we perceived that a data-dependent approach prevails, which has characterized him during his tenure. On the other hand, the main subject touched upon by the other three members –in our opinion more dovish– was the outlook for inflation, which was the main driver behind their vote for a pause. Their comments suggest that, if a favorable outlook materializes after the inflation ‘hump’ in 2Q21, cuts could resume. Meanwhile, we consider some differences in opinion among them are starting to be seen, with one –which we consider was Deputy Governor Jonathan Heath– highlighting other risks. Among them, he noted: (1) Doubts about the path of inflation convergence; (2) possible external financial shocks; (3) stability of the financial system; (4) evolution of the pandemic and vaccinations; and (5) challenges of maintaining a low reference rate. Considering our outlook for growth and inflation, we believe he could skew towards a neutral or even slightly hawkish bias in upcoming decisions.

We expect the next move to be a 25bps hike in December. Despite most members believing the easing cycle could continue, we consider conditions laid out for that to happen will not materialize. Specifically, our outlook sees a more challenging backdrop in several fronts. First and foremost, [we expect higher inflation relative to the central bank’s forecasts for the remainder of the year.](#) Although we expect a moderation in 3Q21 after the ‘hump’ of the previous quarter, our trajectory does not anticipate annual inflation falling below the 4% upper bound in said period, climbing later to 4.7% by the end of the year. Second, and partly related to this, we expect a better outlook for growth relative to the central institute, which would result in the output gap possibly closing at a faster pace than previously expected (despite remaining negative). We recognize the risk of an heterogenous recovery, which could skew Banxico to maintain an accommodative stance for longer. Third, we believe pressures in financial assets could continue given expectations of higher inflation globally. This will probably keep commodities prices and government bond yields high, favoring investments in countries with more attractive rates. Fourth, there are risks associated with a possible tightening of the relative monetary stance. Some EMs with similar profiles to Mexico (*e.g.* Brazil) could restrict –in some cases further– their monetary position, pressuring investment flows. We also expect the Fed to start giving signs of tapering in 2H21, which could result in an additional impact on financial markets. Lastly, we highlight concerns about idiosyncratic factors, such as the evolution of the sovereign credit rating, the financial position of Pemex, investment climate, and the possibility of a fiscal reform after the election. Hence, we now expect the next move from Banxico to be a 25bps hike in the December 16th meeting, taking the reference to 4.25% by year-end. After this, we think there could be more increases in 1Q22, with the depth and magnitude still uncertain and dependent on the economic outlook and data, mainly inflation.

From our Fixed income and FX strategy team

The local yield curve holds a slightly more aggressive pricing on Banxico's future movements. The local fixed-income market experienced positive reaction to the minutes' release, with Mbonos strengthening around 3bps for a 7bps rally, on average, extending the strong performance witnessed in the last sessions which was also supported by the CPI reading released earlier today in line with market expectations. Meanwhile, the curve's pricing on future movements for the central bank expose implied hikes of 18bps for the 3Q21 and 31bps for the 4Q21, which although is consistent with our view of a more restrictive stance for year-end considering our estimate of the reference rate closing 2021 at 4.25%, reflects a market with a slightly more aggressive expectation on the space of potential adjustments of the central bank in the short-term. We consider that local inflation dynamics for the remainder of the year, Banxico's bias, and the possibility of observing new pressures in long-term US rates could trigger new volatility phases, reason why we prefer to wait for better entry levels for long positions in the local yield curve, where we identify a greater relative valuation for longer-term securities.

In the foreign exchange market, the Mexican peso has benefited from a global scene favoring risk assets, currently trading close to 20.15 per dollar under a currency backdrop in which the USD has moderated its most recent strengthening due to the dovish bias exposed in the Fed's minutes published yesterday. Meanwhile, Banxico's position holding the MXN attractive carry in the following months will be key support for the currency, although we expect a still volatile path with space for additional appreciation ($\sim +2.8\%$) when trading close to 19.50 and pressures associated with the market hedging the local electoral process at the end of this quarter.

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We, Gabriel Casillas Olvera, Alejandro Padilla Santana, Delia María Paredes Mier, Juan Carlos Alderete Macal, Manuel Jiménez Zaldivar, Marissa Garza Ostos, Francisco José Flores Serrano, Katia Celina Goya Ostos, Santiago Leal Singer, José Itzamna Espitia Hernández, Valentin III Mendoza Balderas, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez, Gerardo Daniel Valle Trujillo, Eridani Ruibal Ortega and Juan Barbier Arizmendi, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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GRUPO FINANCIERO BANORTE S.A.B. de C.V.

Research and Strategy			
Gabriel Casillas Olvera	IRO and Chief Economist	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godínez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611
Economic Research and Financial Market Strategy			
Alejandro Padilla Santana	Executive Director of Economic Research and Financial Markets Strategy	alejandro.padilla@banorte.com	(55) 1103 - 4043
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251
Economic Research			
Juan Carlos Alderete Macal, CFA	Director of Economic Research	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Francisco José Flores Serrano	Senior Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Katía Celina Goya Ostos	Senior Economist, Global	katia.goya@banorte.com	(55) 1670 - 1821
Luis Leopoldo López Salinas	Economist, Global	luis.lopez.salinas@banorte.com	(55) 1103 - 4000 x 2707
Market Strategy			
Manuel Jiménez Zaldívar	Director of Market Strategy	manuel.jimenez@banorte.com	(55) 5268 - 1671
Fixed income and FX Strategy			
Santiago Leal Singer	Senior Strategist, Fixed Income and FX	santiago.leal@banorte.com	(55) 1670 - 2144
Leslie Thalía Orozco Vélez	Strategist, Fixed Income and FX	leslie.orozco.velez@banorte.com	(55) 5268 - 1698
Equity Strategy			
Marissa Garza Ostos	Director of Equity Strategy	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Senior Strategist, Equity	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Senior Strategist, Equity	valentin.mendoza@banorte.com	(55) 1670 - 2250
Víctor Hugo Cortes Castro	Senior Strategist, Technical	victorh.cortes@banorte.com	(55) 1670 - 1800
Eridani Ruibal Ortega	Analyst	eridani.ruibal.ortega@banorte.com	(55) 1103 - 4000 x 2755
Juan Barbier Arizmendi, CFA	Analyst	juan.barbier@banorte.com	(55) 1670 - 1746
Corporate Debt			
Hugo Armando Gómez Solís	Senior Analyst, Corporate Debt	hugo.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Analyst, Corporate Debt	gerardo.valle.trujillo@banorte.com	(55) 1670 - 2248
Economic Studies			
Delia María Paredes Mier	Executive Director of Economic Studies	delia.paredes@banorte.com	(55) 5268 - 1694
Miguel Alejandro Calvo Domínguez	Senior Analyst, Economic Studies	miguel.calvo@banorte.com	(55) 1670 - 2220
Wholesale Banking			
Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(81) 8319 - 6895
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.cebaldos@banorte.com	(55) 5268 - 9996
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Frigolet Vázquez Vela	Head of Sólida Banorte	alejandro.frigolet.vazquezvela@banorte.com	(55) 5268 - 1656
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Carlos Alberto Arciniega Navarro	Head of Treasury Services	carlos.arciniega@banorte.com	(81) 1103 - 4091
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
Lizza Velarde Torres	Executive Director of Wholesale Banking	lizza.velarde@banorte.com	(55) 4433 - 4676
Osvaldo Brondo Menchaca	Head of Specialized Banking Services	osvaldo.brondo@banorte.com	(55) 5004 - 1423
Raúl Alejandro Arauzo Romero	Head of Transactional Banking	alejandro.arauzo@banorte.com	(55) 5261 - 4910
René Gerardo Pimentel Ibarrola	Head of Corporate Banking	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Commercial Banking	victor.rolan.ferrer@banorte.com	(55) 5004 - 1454